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C O N F I D E N T I A L SECTION 01 OF 04 RPO DUBAI 000468

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TAGS: ECON IR PGOV PHUM PREL
SUBJECT: IRAN: AHMADINEJAD GETS HALF OF WHAT HE WANTS ON SUBSIDY

REFORM

DUBAI 00000468 001.2 OF 004

CLASSIFIED BY: Alan Eyre, Director, Iran Regional Presence
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REASON: 1.4 (b), (d)

¶1. (C) SUMMARY: Iran's Majlis has vigorously debated and ultimately approved the first part of President's Ahmadinejad's proposed subsidy reform bill. The bill is a two-part program intended to end state subsidies on energy, utilities and basic food items and channel the savings as cash payments to low-income groups. Despite criticism that the proposal could add to Iran's inflation, lawmakers overwhelmingly passed five of the 14 articles with only one change: to lengthen the period over which the subsidies should be gradually eliminated. The Majlis will take up the second half of the bill when it reconvenes November 1, and there are indications that possible changes to the cash payments provisions will be contentious. In getting the first part of the bill passed, Ahmadinejad has rebounded from a pre-election legislative defeat and is on the verge of a victory that could have a major impact on the Iranian economy. The vote to end the politically popular subsidies suggests that there is an increasing awareness in the IRIG that subsidies are no longer financially sustainable. A dditionally, given the Supreme Leader's earlier general endorsement of subsidy reform, it seems probable that a subsidy reform bill in some form will be enacted. END SUMMARY.

Subsidy Reform: Majlis 1, Ahmadinejad 1

¶2. (C) On October 11, the Majlis approved the first part of President Ahmadinejad's subsidy reform bill by a vote of 116 in favor, 42 against and 12 abstentions. In the face of strong criticism over the potential to further increase inflation, effective government lobbying and broad-based agreement that the IRIG will be unable to afford subsidies in the future pushed Majlis to approve the first five articles of the bill, liberalizing prices for a substantial number of items over five years as follows:

-- Article 1: General framework for targeted subsidies.

-- Article 2: Gasoline imports.

-- Article 3: Other energy imports and utilities (electricity

and water).

-- Article 4: Wheat, rice, oil, milk, and sugar as well as postal and transportation services. MPs did not approve subsidy removal for pharmaceutical products.

-- Article 5: Bread and flour.

(NOTE: While the legislation does not dictate how the government should implement the cuts, the expectation is that it will increase prices annually, 20 percent at a time, to make up the difference between current subsidized prices and a liberalized price determined by a good's price in the region. END NOTE.)

¶3. (C) During the debate, numerous MPs took the floor to criticize the bill, arguing it would create higher inflation, one predicting a 20 percent increase and another 60 percent. MP Hasan Vana'i, who led opposition to the bill, said subsidy reform should wait until after other reforms are enacted. "We must first tackle the country's economic infrastructure. We must ensure that we have the capacity to produce and distribute~otherwise, the implementation of this bill will lead to a rise in prices."

¶4. (C) The comments of MPs opposed to the bill echoed the comments of some experts. One Iran-trained economist who describes himself as a free-market proponent shared his concern with EconOff, arguing "You cannot have a free domestic market without free trade and without privatized distribution networks. In Iran, with government and public companies still controlling exports and imports (after subsidies are removed), the free market will fail to re-distribute...causing dramatic changes in CPI and prices." Editorials making similar arguments were

published in a number of economic-oriented newspapers and online. Debate over the bill continued to intensify as MPs considered individual articles of the bill.

¶5. (C) President Ahmadinejad dedicated large amounts of time in supporting this bill, linking those who were against the program as being opposed to its ideological underpinnings rather than the need for economic reform. Ahmadinejad effectively countered criticism of the bill by his unrelenting focus on the current subsidy program's inequities and references to 'over-consumption' by wealthier Iranians. On October 11, he participated in a one-hour discussion on state television with two economists to debate the bill's specifics. Ahmadinejad described in detail four goals for removing subsidies: (1) providing justice so people enjoy public resources equally, (2) optimizing resources so people allocate goods for themselves most efficiently, (3) preventing waste of resources so people consume more realistically, and (4) a first step in a broader effort to reform the country's economic infrastructure. Ahmadinejad rebuffed technical questions about how the subsidies would be removed and cash payments would be made, instead focusing on the necessity for reform and justice while expressing disdain for those who "benefit from the chaotic distribution of subsidies, and are now economically at a higher level than others." A Tehran-based university professor who knows the two economists who participated in the debate told EconOff that they told her afterwards that they were not allotted any time to express concerns, that "the discussion was one-way," and that the way "Ahmadinejad portrayed the issue about justice made it difficult to disagree."

The Costs of Subsidies

¶6. (C) Regardless of Ahmadinejad's ideological arguments, there is a growing realization within the IRIG that the subsidy program has become a drain on the Iranian economy, even if advantageous for consumers who buy goods at below market prices and for domestic producers who sell to the government at set prices. As a result, the entire subsidy program costs the government approximately USD 90 to 100 billion annually, approximately one-third of national GDP. While one-third of the annual budget is allocated for subsidy payments, the government has often had to go outside of the budget process and dip into the country's Oil Stabilization Fund (OSF) to fund the program. As a result, the government in recent years has been accused of 'stealing' money by not following the budgetary process to make large subsidy payments. (NOTE: While Iran does not publish the OSF balance, numerous business analysts believe that it is close to zero and is driving the government's call for reform. END NOTE.)

The Example of Energy

¶7. (SBU) Energy subsidies are one such example of the difficulties the government faces in trying to introduce reform through eliminating politically popular subsidies.Energy consumption has grown at twice the rate of GDP (today it is at 10 percent) over the last two decades and energy subsidies have driven the high growth and disproportionately benefited the affluent. They have also encouraged a large gasoline smuggling operation. By the government's own admission, 10 to 12 million liters of subsidized gasoline (one-sixth of daily consumption) is smuggled out of the country daily. In attempt to reduce gasoline consumption and liberalize pricing, the government introduced gasoline rationing two years ago. Even though the rationing program was considered to be a modest initiative, it resulted in public protest and the torching of a dozen gas stations in Tehran. After two years though the program has been declared a success (gasoline consumption growth has slowed and the amount spent on subsidies decreased) and helped pave they way for further reform. (NOTE: Using smart cards, the government limits subsidized gasoline (USD 0.11/liter) to 100 liters per vehicle per month after which consumers are required to pay market prices (USD 0.40/liter). END NOTE.)

Building Consensus on Subsidies

¶8. (C) President Ahmadinejad re-introduced comprehensive subsidy reform in early 2009 as part of the annual budget but the Majlis refused to approve it after Ahmadinejad refused to entertain any changes to the bill and fearful Ahmadinejad was spinning the cash component as a populist measure intended to buy votes for his re-election (reftel). The bill was then deferred to a special Majlis committee for further review. There was no mention of the bill by the government again until Ahmadinejad was inaugurated for his second term and declared passage of the bill a top priority as well as "the most important (economic legislation) in the past 50 years."

¶9. (SBU) At the President's urging, the bill emerged from committee and the Majlis began debate on it in an open session on October 11. Both the government and numerous Majlis members made the case that the nine-month review had produced a more

robust bill that addressed numerous concerns raised earlier about inflation and the process of providing payments to lower-income Iranians. As one member of the committee explained in an interview with the Iran Student News Agency, it met 53 times, with 136 hours of discussion among officials and outside experts.

¶10. (SBU) The review resulted in three key changes to the bill. First, in order to help avoid price shocks, the committee recommended that the government remove subsidies over five years, instead of three as originally proposed. Second, to keep inflation in check, it recommended that the bottom 50 percent of the population receive substitutes for subsidies, instead of the original 70 percent the government proposed. As part of this recommendation, the committee emphasized the increased use of social safety net programs rather than strictly cash payments. Lastly, to keep the power of the government in check, the committee recommended the savings achieved by ending subsidies be deposited in the Treasury and the government make requests to spend the money through the budget process, instead of allowing the government to spend the funds without oversight as originally proposed.

¶11. (C) COMMENT: In the midst of political posturing between Ahmadinejad and his critics in the Majlis, the government's ability to marshal the support of MPs required to end subsidies over the next five years is impressive. Beyond the legislative victory, however, the larger question in what it portends for the Iranian economy. Some IRPO contacts who follow the Iranian economy closely insist that while price liberalization is a good idea in theory, if the government fails to liberalize other components of the economy that govern price, the result will be hyper-inflation. Regardless, a consensus has formed that the country can no longer afford to pay such large subsidies given its precarious fiscal standing. Though it remains unclear to what degree cash payments will affect inflation, ending subsidies seems to be no longer a point of debate.

¶12. (C) COMMENT (Cont'd.): The larger controversy over the bill though is yet to come. Doubts about the cash payment aspect of the bill are starting to become more pronounced and more public. There is a general concern that the government's actions to classify different levels of economic strata have been haphazard and incomplete. Other experts argue that cash payments are economically inefficient and will only stoke inflation. Average Iranians quoted in press reports are skeptical whether the government will actually use the funds saved from subsidies to improve the economy or will channel it to those with government connections. Cash payment compensation and re-distribution of wealth though is "what drives the Ahmadinejad administration's zeal for this bill," according to an Iranian economist, who is an expert on the Middle East and currently a visiting professor at an Ivyleague university. As such, whether the targeted

subsidy reform will pass depends heavily on how the debate over cash payments plays out in the coming weeks, what changes the Majlis agrees on, and if the government accepts them. Additionally, once the Majlis approves the bill, the Guardian Council will have to review it for ratify it before it becomes law. In light of the Supreme Leader's endorsement of subsidy reform earlier this year as well as his categorization that this is 'the year of reforming consumption,' it seems probable that some sort of subsidy reform will be enacted. END COMMENT.
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